

Part I

Section 355.—Distribution of stock and securities of a controlled corporations

26 CFR 1.355-3: Active Conduct of a Trade or Business

Rev. Rul. 2007-42

ISSUE(S)

Under the facts described below, is a corporation (D) that owns a membership interest in a limited liability company (LLC) classified as a partnership for Federal tax purposes engaged in the active conduct of a trade or business for purposes of § 355(b) of the Internal Revenue Code?

FACTS

Situation 1.

LLC is a domestic limited liability company that has been classified as a partnership for Federal tax purposes since its date of organization. For more than five years, LLC has owned several commercial office buildings that are leased to unrelated third parties. LLC has one class of membership interests outstanding. For more than five years, D has owned a 33 1/3-percent membership interest in LLC, and has owned all the stock of a subsidiary (C), a corporation that has been engaged for more than five years in the active conduct of a trade or business that is unrelated to D's activities.

LLC continuously seeks additional properties to expand its rental business. When a property is located, LLC negotiates its purchase and financing and determines whether renovations or alterations are necessary to make the building suitable for rental. LLC periodically repaints and refurbishes its existing properties.

Pursuant to the terms of its leases, LLC provides day-to-day upkeep and maintenance services for its office buildings. These services include trash collection, ground maintenance, electrical and plumbing repair, and insect control. Additionally, LLC advertises for new tenants, verifies information contained in lease applications, negotiates leases, handles tenant complaints, prepares eviction notices and warnings for delinquent tenants, collects rent, and pays all expenses, including gas, water, sewage, electricity and insurance for the office buildings. LLC also maintains financial and accounting records to reflect income and expenses relating to each of its rental properties as well as LLC's general expenses.

The above described activities of LLC have been conducted for more than five years. The employees of LLC perform all management and operational functions with respect to LLC's rental business. Neither D nor any other member of LLC performs services with respect to LLC's business.

For a valid business purpose, D proposes to distribute all its C stock pro rata to D's shareholders in a transaction intended to satisfy the requirements of § 355.

Except for the issue of whether D is engaged in the active conduct of a trade or business under § 355(b), the transaction will otherwise meet all the requirements of § 355.

Situation 2.

The facts are the same as Situation 1 except that D owns a 20-percent membership interest in LLC.

LAW AND ANALYSIS

Section 355(a) provides that, under certain circumstances, a corporation may distribute stock or securities in a corporation it controls to its shareholders or security holders in a transaction that is nontaxable to such shareholders or security holders. Sections 355(a)(1)(C) and 355(b) require that both the distributing and controlled corporations be engaged, immediately after the distribution, in the active conduct of a trade or business that has been actively conducted throughout the five-year period ending on the date of distribution.

Section 1.355-3(b)(2)(ii) of the Income Tax Regulations, in defining "trade or business" for purposes of § 355, provides that a corporation is treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of activities ordinarily must include the collection of income and the payment of expenses.

Section 1.355-3(b)(2)(iii) provides that the determination whether a trade or business is actively conducted will be made from all the facts and circumstances. Generally, for a trade or business to be actively conducted, the corporation is required itself to perform active and substantial management and operational functions. Generally, activities performed by the corporation itself do not include activities performed by persons outside the corporation, including independent contractors. A

corporation may, however, satisfy the active trade or business test through the activities that it performs itself, even though some of its activities are performed by others.

Under § 1.355-3(b)(2)(iv), the active conduct of a trade or business does not include the holding of property for investment purposes. It also does not include the ownership and operation (including leasing) of property used in a trade or business, unless the owner performs significant services with respect to the operation and management of the property.

The fact that a partnership engages in activities that would constitute the active conduct of a trade or business if conducted by a corporation does not necessarily mean that each partner in the partnership is considered to be engaged in the active conduct of a trade or business for purposes of § 355(b). In such a case, the determination of whether a partner is considered to be engaged in the active conduct of a trade or business must be based on the requirements of § 355 and the regulations thereunder taking into account the activities of the partner (if any), the partner's interest in the partnership, and the activities of the partnership.

Rev. Rul. 92-17, 1992-1 C.B. 142, considers whether D, a corporate general partner in a limited partnership, is engaged in the active conduct of a trade or business within the meaning of § 355(b). For more than five years, D owned a 20-percent interest in LP, a limited partnership that owned several commercial office buildings leased to unrelated third parties. D's officers performed active and substantial management functions with respect to LP, including the significant business decision-making of the partnership, and regularly participated in the overall supervision, direction, and control of LP's employees in operating LP's rental business. Rev. Rul. 92-17

concludes that D is engaged in the active conduct of a trade or business within the meaning of § 355(b). Rev. Rul. 2002-49, 2002-2 C.B. 288, reaches a similar conclusion where D and another corporation (X) each own a 20-percent interest in a member-managed LLC that is classified as a partnership for Federal tax purposes and D and X jointly manage the LLC's business.

By comparison, § 1.368-1(d)(4)(iii)(B), regarding the continuity of business enterprise requirement applicable to corporate reorganizations, provides that the issuing corporation will be treated as conducting a business of a partnership if members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business. Those regulations indicate that a one-third interest in the partnership represents a significant interest in the partnership business, and a corporation that owns such interest but does not perform active and substantial management functions for the business of the partnership is nevertheless treated as conducting the business of the partnership.

In Situation 1, D is engaged in the active conduct of LLC's rental business for purposes of § 355(b) because D owns a significant interest in LLC and LLC performs the required activities that constitute an active trade or business under the regulations.

In Situation 2, D is not engaged in the active conduct of LLC's rental business for purposes of § 355(b) because D neither owns a significant interest in LLC nor performs active and substantial management functions for LLC.

HOLDING

In Situation 1, D is engaged in the active conduct of a trade or business for purposes of § 355(b).

In Situation 2, D is not engaged in the active conduct of a trade or business for purposes of § 355(b).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 92-17 is modified to the extent it indicated that a partner must perform management functions in order for the partner to be treated as engaged in the active conduct of the trade or business of the partnership.

DRAFTING INFORMATION

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